

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

EXHIBIT 2.2A

ANALYSIS OF U.S. PADDING CORP V. COMMISSIONER OF INTERNAL REVENUE 88 T.C 177 (1987), aff'd 865 F.2d 750, 89-1 USTC ¶9573, 63 AFTR2d 89-511 (6th Cir. 1989)

In this court case the IRS interpretation of IRC section 1504 (d), " a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country", was clarified.

U. S. Padding Corp. (USPC) was a textile manufacturer whose main customers were involved in the automobile industry. In 1977, USPC diversified into the garment industry and bought a defunct Canadian manufacturer, on September 9, 1977. This purchase was conditioned on the Canadian government's approval of USPC's operation in Canada under the Foreign Investment Review Act. (FIRA)

FIRA required foreign corporations to apply for permission from the Foreign Investment Review Agency (Agency) to operate in Canada. The stated purpose of the Act was to maintain Canadian control over the Canadian economy. Permission to operate a new business in Canada was granted if the new business would be of "significant benefit" to Canada. The Agency submitted its recommendation to the Minister of Industry, Trade and Commerce. The Canadian Cabinet, also called the Governor-in-Council, made a final decision. (FIRA was repealed in 1982 and replaced with the Investment Canada Act (ICA) effective June 30, 1985.)

The Act did not require foreign businesses to incorporate in Canada, but 90-95% did incorporate and Canadian attorneys routinely advised them to do so because their experience with the Agency indicated that, especially with respect to small businesses with few employees, which did not focus on exports, technology or research and development, incorporation was highly advisable.

USPC formed a new Canadian Corporation, Trans Canada Non Woven Ltd., (Trans Canada), on September 26, 1977. USPC claimed that it did this on the advice of numerous Canadian attorneys, who advised them that FIRA approval would be easier and quicker to acquire if Trans Canada were incorporated in Canada. USPC further indicated that it would have preferred not to incorporate because Canadian incorporation was not required and that it was not impossible for unincorporated businesses to be approved. However, USPC was advised that a business not incorporated in Canada would need to show that it would provide other benefits to Canada.

On November 4, 1977, the application for FIRA approval was submitted to the Agency.

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Trans Canada was notified of the Agency's approval in a letter dated January 25, 1978.

USPC filed consolidated federal 1120 tax returns in 1978 and 1979 with Trans Canada. The IRS ruled that Trans Canada was not a domestic corporation within the meaning of IRC Section 1504(d) and could not file consolidated returns.

At trial, USPC claimed that Trans Canada qualified as a subsidiary under 1504(d) because the administrative practice of the Agency was to recommend approval only when the applicant was a Canadian corporation. The IRS argued the plain language of the Act indicated that only an explicit statutory or regulatory requirement of incorporation justifies the use of consolidated returns and no such requirement existed here. In addition, the IRS claimed that, even if policies and practices could be considered, no policy or practice required incorporation in Canada.

The tax court reasoned that Section 1504(d) states that consolidation is allowed when the "laws of a contiguous country" require incorporation in that country and that Canadian practice and policy constituted "laws of a contiguous country". Thus the court held that incorporation was necessary because such incorporation was "favored if not required" by the agency.

On appeal, the IRS conceded that an administrative practice or policy would qualify as a "law" under Section 1504(d). Thus, the only unresolved issue on appeal was whether Canadian practice or policy "required" incorporation in Canada for FIRA approval. The IRS maintained that the legislative history of Section 1504(d) shows Congress's intent to apply the section only where there is a binding requirement of incorporation, which he asserted was absent in Canada. The IRS concluded Trans Canada was not eligible to be included in the consolidated return because the Agency (FIRA) stated that incorporation was not an absolute requirement. The point was made that 5-10% of all foreign business permitted to operate in Canada were branches of foreign corporations. USPC, on the other hand, argued that of all the businesses which operated as branches, none were operating in manufacturing in Canada. Thus if approval was to be granted for a manufacturer, Canadian practice and policy acted as an absolute requirement of Canadian incorporation.

There has only been one other case interpreting Section 1504(d), Booth Fisheries Co. v. Commissioner of Internal Revenue. The IRS sought to distinguish Booth on the basis the Canadian statute in effect at the time "raised a barrier" to foreign businesses not incorporated in Canada, and no such barrier existed during the 1978 and 1979 Padding years.

The court in Padding held the argument was without merit. Not one expert could identify

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a manufacturing company comparable to Trans Canada which had been approved by the Canadian government without Canadian incorporation. All of the experts would have advised Trans Canada to incorporate to secure approval. The Agency itself informed USPC that its application would be greatly enhanced by Canadian incorporation and that, in the absence of incorporation, the business would have to show that it would provide other benefits to Canada to meet the "significant benefits" requirements of the FIRA. Since Trans Canada was involved in manufacturing existing products, there was no reason for anyone to believe that Trans Canada would be able to sustain such a showing. All things considered it appeared that unless Trans Canada incorporated it would be faced with a "barrier" as a foreign corporation applying to operate in Canada.

The IRS argued that USPC was never told that its Canadian operation would not be approved unless it incorporated in Canada, and that only such absolute requirement satisfies Section 1504(d). The IRS's interpretation would require that, in the absence of an absolute written requirement of incorporation, the only way to determine whether incorporation is required is to apply and allow one's application to be rejected. The court did not agree. In light of the evidence, including the advice from the Agency itself, the court of appeals believed the lower court was not erroneous in its judgment.

The IRS's only argument of substance was that the title of Section 1504(d), "subsidiary formed to comply with foreign law", should be read to indicate that congressional intent was that incorporation must be required by foreign law for an operation to qualify under 1504(d). However, there was ample evidence to show that "but" for incorporation, Trans Canada would not have been allowed to operate in Canada. The statute's title does not change the practical reality with which USPC was faced.

The court felt that Trans Canada incorporated solely for the purpose of obtaining FIRA approval. In fact, it sacrificed its ability to obtain credit with ease from American banks, with which it had long-standing relations, in order to assure Canadian approval. As a result the U.S. Court of Appeals found Trans Canada was within the meaning of I.R.C. 1504(d), even though Canadian law did not expressly require the incorporation of the business conducted by the subsidiary in Canada. The term "laws of such country" was interpreted to include any existing practice or policy of such country that results in a U.S. parent finding it necessary to incorporate its foreign operations under the laws of the foreign country in order to insure that the government would grant its approval to the U.S. corporation to operate and maintain the business. As a result, there was no basis for concluding that the tax court's ruling was erroneous and thus in its decision dated 1/12/89, the U.S. Court of Appeals affirmed the tax court's decision in favor of U.S. Padding Corp.